DEVELOPMENT OF FEDERAL REGULATION OF FUTURES TRADING

A talk by J. M. Mehl, Chief of the Commodity Exchange Administration, at a luncheon meeting of the Federal Bar Association, March 6, 1941.

I am happy to have this opportunity to talk to members of The Federal Bar Association. Federal attorneys have played an important part in the development of Federal regulation of futures trading.

The Commodity Exchange Administration, one of the smaller bureaus of the Department of Agriculture, is responsible for supervision of futures trading in agricultural commodities on the nation's boards of trade and commodity exchanges. From the standpoint of legal work, the experience of the bureau has been similar to that of many other Federal agencies. It had its beginnings twenty years ago -- in a new field, under a new law, with little legal experience, and stiff court tests ahead. Today Federal regulation of futures trading is a tried and accepted function of democratic government; and the nation's commodity markets are a much healthier place to do business. Federal attorneys have helped to make possible this result; and I believe it illustrates how lawyers in the service of the Federal Government are doing their part to make democracy work.

I can say this sincerely because when I first came to Washington I had a terrible time with Government lawyers. To me they were the perfect example of a fifth wheel. I feel free to speak about this since I see here some representatives of the

Solicitor's office of the Department of Agriculture where I first learned about Government lawyers. I was a subject matter specialist. I knew more about the situation in my particular field than anyone in the Solicitor's office could know. I was licensed to practice law. What more was needed? That was my attitude; but I got over it. I used to spend hours searching the law libraries for authorities to prove that the Government lawyers were wrong. I got over that too. It is amazing how easy it is, in a place like the Supreme Court Library, to find authorities to support almost anything that an administrator hopes can be done. It finally dawned on me that the administrator of a Federal agency trying to be his own lawyer is in about the same position as a lawyer trying to prosecute his own private lawsuit without the aid of other counsel. He may be good but not that good.

How a Court Case Affected Regulatory Work

Just how important a point of law can be in Federal regulation of futures trading was illustrated in the well-known Cutten case. In 1935 a large trader named Cutten was charged with repeated attempts to manipulate the price of grain. Under the old Grain Futures Act, a person could not be criminally prosecuted for attempting to manipulate or corner the market. But it seemed to be the clear intention of the law to exclude such a person from the markets. However, the wording of the law was peculiar. It said the Secretary of Agriculture could have such a person excluded if he "is attempting to manipulate." The "is" was the significant word. The Supreme Court interpreted the language to mean that the

Secretary could not act if manipulation was completed. In other words, where manipulation was successfully accomplished, there was nothing we could do about it. But not for long. In 1936 the Grain Futures Act was amended; its short title changed to Commodity Exchange Act; and manipulations and corners were made criminal offenses. Now offenders may be prosecuted for completed acts of manipulation as well as those in the making.

Early Development of Futures Trading

You are probably familiar with the general background of futures trading. The making of contracts for future delivery of agricultural products and other commodities is nearly a hundred years old in this country. There are earlier antecedents in Europe and Asia. It attracted notice in the United States during the fifties. To assure supplies of mid-western grain, particularly for eastern and foreign buyers, Chicago dealers would make contracts several months in advance. A lively trade in "futures" developed. During the Civil War futures trading grew to large proportions in connection with supplying grain for the army; and in 1865 the Chicago Board of Trade adopted rules recognizing futures trading as a distinct commercial practice. Since then, futures markets have been developed in cotton, wool tops, fats and oils, and many other commodities. The annual volume of trading runs into several billions of dollars. Futures prices on the large markets are quoted throughout the United States and to a large extent determine the going cash prices of farm products.

Development of Federal Regulation

Notwithstanding the essential economic services performed by the futures markets in reflecting supply and demand conditions, the exchanges were early subject to excessive speculation and other abuses. Efforts for Federal intervention date from the eighties. The basic law under which we operate today was enacted in 1922. The act covered only grains. It was limited in scope and provided mainly a fact-finding agency. In 1936 the short title was changed to Commodity Exchange Act. Additional commodities such as cotton, butter and eggs were added; and the regulatory responsibilities were extended. Wool tops were added in 1938; and in 1940 many other commodities, including all fats and oils. You are familiar with the fact that some commodities are traded in on more than one market. For example, wheat is traded in on eight markets. Altogether, 18 markets are under supervision, and all but a few of the agricultural commodities in which futures trading is conducted.

Organized vs. Unorganized Speculation

You may ask, as we are constantly being asked, why we have regulation of futures trading. Why not prohibit it altogether? Why have this device for speculating in wheat and cotton by a lot of folks who have no interest in these commodities? That's a big question, too big for me to attempt to answer completely in the time we have here today. There is a lot of speculation in the futures market under normal conditions and there is trading of a kind that may be termed gambling. It is unfortunate, however, that some people regard futures trading and speculation as

synonymous terms. Some think we would prohibit speculation if we prohibited futures trading. That's not true. In the absence of government-fixed prices for commodities such as wheat and cotton, it is inevitable that there be speculation in those commodities. It is a question of choosing between organized speculation through the medium of a futures market and unorganized, and often harmful, speculation in the actual commodities.

I believe it may be better to have speculation conducted openly in futures on established exchanges where it can be under government supervision and subject to some control. Channeled through these markets it can serve a useful economic purpose in enabling marketing organizations and dealers who want to avoid speculative risks -- who are interested merely in service profits for merchandising and distributing -- to pass price risks on to the body of speculators who are willing to assume these risks.

How Hedging Works

Trading in futures as a form of price protection is commonly called hedging. To get an idea of hedging, let's take an example and see how it works. For purposes of simplification, shipping charges and commission costs are omitted.

A cooperative grain elevator in Iowa buys 15,000 bushels of corn, on which it must realize 50 cents a bushel to come out satisfactorily. The corn is consigned to an eastern market for sale, but before it arrives the price drops 10 cents. Instead of running this risk, the elevator might have sold an equivalent amount of corn futures concurrently with its purchase of the

actual corn. Assume the price of the future to be 53 cents a bushel, and that the price of this future also drops 10 cents a bushel by the time the consigned corn reaches the market. The elevator then is able to close the futures sale by a purchase at 43 cents which results in a profit exactly offsetting the decline in the cash market.

The example of hedging by a farmers' elevator is roughly applicable to dealers, millers, and other processors who buy the actual commodity for distribution in trade channels. They sell futures in offsetting quantities simply as a form of insurance. They have no intention of delivering on these futures contracts, because they have more advantageous outlets. Their operating margins are such that they cannot afford to risk a price decline between the time they buy the actual commodity and the time they are able to merchandise it. To do so would mean a larger handling charge and an increase in the cost of marketing. And so there is an institutional aspect as regards futures trading and speculation in commodities that may not be ignored if we seek economy in distribution.

The Need for Regulation

There are also many abuses. There are opportunities for cheating and fraud, making regulation necessary. The markets have been manipulated against the interests of both producers and consumers. There was a time when the Hutchinsons and the Leiters, and the other so-called "playboys" of speculation, used these public market places as a stage on which to parade their power

over prices. They were the market leaders. Their operations churned the markets up and down without regard to fundamental conditions. They attracted followers by the thousands -- suckers, if you please, who made no appraisal of supply and demand conditions, but simply gambled on what the market leaders would be able to do.

The enforcement of the Commodity Exchange Act has effectively curbed the playboys of speculation, and the planned raids that occurred so often in the "good old days." This thing of large speculators using superior skill and knowledge of the market to take the public for a "ride" now invites fine and imprisonment. Since the law of 1936 went into effect, large-scale attempts to manipulate market prices have been few. Large traders in the important agricultural commodities are required to make daily reports of their transactions. The books of futures commission houses are periodically audited. In this way the Commodity Exchange Administration keeps close watch, not only on the activities of the big professional speculators but also on those in the cash business who have sometimes used the futures market speculatively to squeeze legitimate hedgers and traders.

Limitations on Speculative Trading

Sometimes large-scale speculation may adversely affect prices even though there is no intention to manipulate the market or take advantage of the trading public. Sometimes the market may turn against a speculator who has large holdings at a time when he is unable to obtain additional credit, and heavy liquidations may

result. Recognizing this, the law of 1936 attempted to make provisions for automatic limitation of excessive speculation. It gives to a body known as the Commodity Exchange Commission, composed of the Secretary of Agriculture, the Secretary of Commerce and the Attorney General, the power to fix absolute limits on the volume of a commodity that a man may buy or sell speculatively for future delivery. So far, this power has been exercised only with respect to grains and cotton. The limitations do not apply to bona fide hedging operations. The limits make it difficult, if not impossible, for large traders to work the deals from which the markets suffered in former years.

While the Commodity Exchange Commission, a body of three cabinet members, shares with the Secretary of Agriculture some of the responsibility in special types of regulatory work, most of the day to day work of trading supervision is carried on by the Commodity Exchange Administration acting for the Secretary of Agriculture.

Close Relation Between Commodity Exchange Regulation and Agriculture

The work of the Commodity Exchange Administration is closely integrated with the other work of the Department of Agriculture. There is good reason for this. The Grain Futures Act of 1922 was one of a series of important agricultural acts which grew out of the farm depression following the World War. This act was closely associated with the cooperative marketing acts and other agricultural legislation enacted after long years of effort by

farmer cooperatives and the farm organizations. Over the years, the additions to the regulatory legislation were sponsored by agricultural interests working in cooperation with the Department of Agriculture. Moreover, the work of the Commodity Exchange Administration is closely related to the bureaus of the department having to do with warehousing, with marketing and with the application of grades and standards for commodities. It is impossible to think of future trading in agricultural commodities except in terms of producer interests.

The Outlook in Federal Regulation of Futures Trading

In looking back, the pioneering work of organized agriculture has accomplished much in building effective machinery for Federal regulation of futures trading. Large-scale manipulation of the markets is now infrequent. Excessive speculation has been curbed. The rights and privileges of farmer cooperatives in the markets have been maintained and protected. Membership of the large grain marketing organizations on the exchanges has become common. There is need, of course, for continued vigilance. Scarcely a month goes by in our current work without action being taken against some infraction. I am glad to say that most of them are small ones. There may also be need for new legislation to meet changing conditions. Possibly other commodities may be brought under regulation as time goes on.

In futures trading, as in other fields of agricultural marketing and distribution, our economy is much better prepared to meet the impact of the present national emergency than it was in 1914-1918. At that time the Federal Government had very little experience to guide it in meeting difficult marketing problems created by wartime conditions. Today, in respect to futures trading, we have time-tested regulatory machinery, established contacts with the markets and the means of taking action promptly to help cushion the shock of wartime impacts.

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